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USDOC FOR 4320/OFFICE OF NAFTA/GWORD/TFOX; 3134/OIO/WESTERN
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E.O. 12958: N/A
TAGS: ETRD EIND EINV CA
SUBJECT: AUTO AND AIRCRAFT MANUFACTURING INVESTMENT:
CANADIAN GOVERNMENTS REJOIN THE SUBSIDY GAME

REF: (A) TORONTO 0430 (C) 04 TORONTO 0786
(B) TORONTO 0264 (D) CALGARY 068

SUMMARY/INTRODUCTION

¶1. The GOC and the provincial government of Ontario will contribute hundreds of millions of dollars toward investments announced recently in central Canada's auto plants. The federal, Quebec and Ontario governments are also offering large new incentives to the aerospace industry. This marks a significant return to the industrial subsidies game by Canadian governments, after a bipartisan trend toward more market-based policies since 1984 (and a tough bout of deficit- fighting since 1995).

¶2. In large part, these subsidy decisions reflect continued competition among North American and European jurisdictions for major auto and aerospace investments. (It bears noting that U.S.- based firms, such as GM, Ford, and Pratt & Whitney, are top beneficiaries of Canada's industrial incentives). However, governments are also responding to anxiety about Canada's manufacturing competitiveness, which is fostered by several trends:

-- Canada's recently declining share of North American auto manufacturing, as new plants locate increasingly southward;

-- Post- 2001 slumps in aerospace and information technology exports;

-- Concerns about backsliding toward being an exporter of energy, forest products and minerals, after decades of struggle to increase the proportion of higher-value-added exports;

-- The uncertainties faced by intensive users of the U.S.-Canada border (a problem codified by Industry Minister David Emerson as "border risk"), which are thought to be deterring some foreign direct investment; and

-- The appreciation in the value of the Canadian dollar since early 2003.

END SUMMARY/INTRODUCTION

THE ANNOUNCEMENTS

¶3. Ontario provincial funds are provided through the "Ontario Automotive Investment Strategy" which was unveiled in April 2004 with funding of C$500 million (US$400 million) (ref A). GOC funds are provided mainly through Industry Canada (notably a program called Technology Partnerships Canada - TPC) and also through Human Resources and Skills Development Canada. The TPC fund provides funding for corporate research and development which is nominally repayable if products succeed commercially. In practice, TPC mainly funds the aerospace industry and little is repaid. The WTO-consistency of TPC's precursor was successfully challenged in the mid-1990's by Brazil's Embraer, which competes directly in the jet aircraft market with Canada's Bombardier, and that dispute prompted the program's reinvention as TPC.

¶4. AUTOS: On March 2, flanked by representatives of the federal and Ontario governments, General Motors of Canada Limited announced the "Beacon Project" -- C$2.5 billion (about US$2 billion) in investments in its Canadian facilities. Beacon will draw C$235 million in funds from Ontario and C$200 million from the GOC. In November 2004, Ford Motor Co. of Canada announced that it would receive C$100 million from Ontario and a similar amount from the GOC to redevelop its operations. DaimlerChrysler is reportedly planning an auto plant investment which would also draw government support. The key target for governments is a possible investment by Toyota in a new assembly plant in

Ontario, which has not attracted a new auto plant in more than a decade (ref C).

¶5. AIRCRAFT: TPC's single largest beneficiary is Pratt & Whitney Canada Inc., which has received some C$500 million (US$400 million) from TPC. On January 13, 2005, the GOC announced a further C$207 million in TPC funding for Pratt & Whitney to support various aerospace research and development programs. On February 22 the GOC announced C$115 million in TPC funding for Bell Helicopter Textron Canada Limited. Meanwhile, Bombardier, the world's third largest aircraft maker after Boeing and Airbus, is playing Canadian and British jurisdictions against each other to manufacture its new C Series jet. The GOC, Quebec and Ontario have all pledged hundreds of millions in support. Bombardier is based in the Montreal area, like Pratt & Whitney and Bell Helicopter, but it has some facilities in Ontario which stand to win C Series contracts.

EXPORT TRENDS: BACK TO LOGS AND ROCKS?

¶6. Canada's development was driven by successive waves of natural resource extraction (fish, fur, timber, grain, minerals, energy). A core mandate of Canada's trade and industrial policies has always been to reduce this reliance on natural resource-based exports. From the 1890's onward this was approached through high tariffs on imported manufactures, but Canada shifted to a trade-liberalizing policy for autos in the 1960's and for most other goods in the 1980's. By the late 1990's the "value added" goal seemed to have been reached. Canadians built more than twice as many cars as they purchased, and they were successfully exporting not only vehicles but jet aircraft (by Bombardier), telecommunications systems (by Nortel) and nuclear reactors (by AECL).

¶7. Since 2000, a number of factors combined to deflate this success. Simultaneous worldwide slumps in both telecoms and aviation hit Nortel and Bombardier hard (along with many related firms), with sharp and sustained drops in their exports.

¶8. With a lack of major new investments in the auto sector, combined with the closing of some older facilities, Canada's ratio of "vehicle production to sales" - a simple indicator of export success - was slipping (it had peaked in 1995 at more than 2, but by 2003 it had fallen to 1.6). Flattening investment in the auto sector, which could be overlooked while Nortel and Bombardier were setting export records, became a concern when they lost their sparkle.

¶9. Meanwhile, the Canadian dollar appreciated strongly in 2003-04, from under 65 cents to over 80 cents U.S., sharply trimming the competitiveness of Canadian exports in the U.S. market. Ontario policymakers view this as a key cause of recent downgrades in the province's growth outlook (ref A).

¶10. In this context, the impressive run-up in demand and prices for energy, building materials and other commodities over the past few years is a mixed blessing in Canada: good for the resource hinterland, but bad for the manufacturing heartland. Strong commodity demand has resource exports booming in both value and volume. In just three years from 2001-2004, exports of oil and gas grew 49 percent; refined petroleum products, 49 percent; iron and steel, 68 percent; and wood panel products, 99 percent. But for manufacturers, the resource boom has not only driven input costs upward, but can also be seen as a major cause of the currency appreciation that hurts them in both foreign and domestic markets.

¶11. In the past two years, oil, gas and refined petroleum products overtook finished motor vehicles as Canada's main export category. While this is an amazing upset in terms of Canada's development since World War II, it is partly explained (at least for now) by price and currency movements. But with foreign investment (including Asian investor interest) in Canada's oilpatch on a strong upward track (ref B), the reversal could threaten to last unless investment in autos and aerospace makes a comeback.

COULD "BORDER RISK" KILL INVESTMENT?

¶12. Canadian Industry Minister David Emerson, an economist and former industry CEO, has fretted publicly about Canada's trade-dependence and competitiveness since he joined the GOC at the end of 2003. Emerson was quick to acknowledge that the world had shifted since the heyday of the rules-based trading system in the 1990's. "We were in Nirvana because we were trade-dependent, more so than anybody else in the world. All of these institutional arrangements that were being set up were really quite nice for us. . . . The

balance is starting to shift - and it's shifting in worrisome ways."

¶13. Referring to "creeping protectionism" in the United States, Emerson says it has gradually defeated the dispute resolution model. "We can be five, six, seven years out and we're still paying the duties. We're still paying the lumber duties today, and we're getting hit on beef, and we're getting hit on pork . . . And then along comes 9/11. . . You realize that today the border is back. The border is back with a vengeance. It's not fading anymore. It's become a fundamental source of risk. . . Think about global supply chains. . . . You're going to make an investment that is designed to serve the North American if not the world market . . . If those investments are systematically and continuously biased toward the United States because of border risk, we've got some big, big problems in Canada."

¶14. Canadian media have been quick to apply Emerson's analysis to Toyota's impending decision about where to locate a new assembly plant - suggesting that Canada could be knocked out of contention for this and other plum foreign direct investments because of "border risk. Meanwhile, while he stresses that assembly plants are the industry's "anchors," Emerson recently expressed a willingness to assist parts manufacturers as well.

POLICY RESPONSE: DIRECT SUBSIDIES

¶15. Liberal Parties currently hold power in the GOC as well as in Ontario and Quebec. According to observers who are close to the auto sector, the willingness of these governments to put large subsidies into the auto industry reflects three factors:

-- An appreciation that Canada has done disproportionately well in attracting auto industry investment in the past, and in leveraging this investment into broader economic strength, and that this success is worth holding onto;

-- The numbers and concentration of votes represented by auto and aerospace workers in politically critical areas; and

-- A view that there is no alternative but to "play the game" and compete with other jurisdictions (primarily U.S. States but also overseas locations) for auto and aerospace plants.

COMMENT

¶16. Comment: In retrospect, Canadian federal and provincial governments' retreat from "industrial policies" during the 1990's appears to have been driven more by deficit problems than by a permanent change in philosophy. Certain industries - such as autos, aerospace, and the "cultural" sectors - will continue to have a political claim on public resources. If nothing else, the across-the-board retreat provided an opportunity to push a few industries - such as shipbuilding, textiles, footwear, and some agriculture - out of the tent.

DICKSON